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BILL ANALYSIS

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Senate Bill 880 (Substitute S-2 as passed by the Senate)
Sponsor: Senator Gerald Van Woerkom
Committee: Banking and Financial Institutions

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RATIONALE

Annuities are contracts sold by life insurance companies that provide fixed or variable payments to a named individual, the annuitant. These contracts, particularly variable annuities, which are tied to the value of stocks purchased by insurance companies, have become popular investment vehicles in recent years. Some people believe that the Insurance Code should include specific regulations regarding the recommendation and sale of annuity products to senior consumers because some insurance companies, and their appointed insurance producers, reportedly have taken advantage of the growing popularity of this market by selling to older individuals products that may not be suitable for them based on their age and financial situation. The National Association of Insurance Commissioners (NAIC) developed a model law to address this issue and it has been suggested that Michigan adopt legislation based on that model.

CONTENT

The bill would create Chapter 41a ("Annuity Recommendation to Senior Consumer") of the Insurance Code to do all of the following:

- Require an insurance producer or insurer to have reasonable grounds to believe that a recommendation to a senior consumer to purchase or exchange an annuity was suitable to the consumer based on his or her financial situation.**
- Require an insurance producer or insurer to make reasonable efforts to obtain a senior consumer's financial**

information before executing a purchase or exchange of an annuity.

- Require an insurer to establish and maintain a system to supervise recommendations, designed to achieve compliance with the bill, or assure that such a system was established and maintained.**
- Allow the Commissioner of the Office of Financial and Insurance Services (OFIS) to order an insurer or insurance producer to take corrective action for a senior consumer harmed by a violation of the bill.**
- Specify that compliance with National Association of Securities Dealers (NASD) rules would satisfy the bill's requirements regarding the recommendation of variable annuities.**
- Specify situations to which the bill would, and would not, apply.**

"Senior consumer" would mean a person 65 years of age or older. For a joint purchase by more than one party, the purchaser would be considered to be a senior consumer if any of the parties were at least 65.

"Insurance producer" would mean that term as defined in Section 1201 of the Code, i.e., a person required to be licensed under Michigan law to sell, solicit, or negotiate insurance, and would include a business entity licensed as an insurance producer under Section 1205(2) of the Code.

"Recommendation" would mean advice provided by an insurance producer, or an insurer where no producer was involved, to

an individual senior consumer, that resulted in a purchase or exchange of an annuity in accordance with the advice.

"Annuity" would mean a fixed annuity or variable annuity that was individually solicited, whether the product was classified as an individual or group annuity.

Recommendation to Senior Consumer

In recommending to a senior consumer the purchase of an annuity or the exchange of an annuity that resulted in another insurance transaction or series of insurance transactions, an insurance producer, or an insurer if no producer were involved, would have to have reasonable grounds to believe that the recommendation was suitable for the senior consumer on the basis of the facts the consumer disclosed regarding his or her investments and other insurance products and his or her financial situation and needs. Before executing a purchase or exchange of an annuity resulting from a recommendation, the insurance producer or insurer would have to make reasonable efforts to obtain the senior consumer's financial status, tax status, and investment objectives, as well as other information used or considered to be reasonable by the producer or insurer in making recommendations to the senior consumer.

Neither an insurance producer nor an insurer, if no producer were involved, would have any obligation to a senior consumer related to any recommendation, if a consumer did any of the following:

- Refused to provide relevant information requested by the insurer or insurance producer.
- Decided to enter into an insurance transaction that was not based on a recommendation of the insurer or insurance producer.
- Failed to provide complete or accurate information.

An insurer's or insurance producer's recommendation would have to be reasonable under all the circumstances actually known to the insurer or producer at the time of the recommendation.

Insurers' Powers & Duties

An insurer either would have to assure that a system to supervise recommendations that was reasonably designed to achieve compliance with Chapter 41a was established and maintained, or would have to establish and maintain such a system, including maintaining written procedures and conducting periodic reviews of its records that were reasonably designed to assist in detecting and preventing violations of the chapter. An insurance producer either would have to adopt a system established by an insurer to supervise recommendations of its insurance producers that was reasonably designed to achieve compliance with Chapter 41a, or would have to establish and maintain such a system, including maintaining written procedures and conducting periodic reviews of records that were reasonably designed to assist in detecting and preventing violations of the chapter.

An insurer could contract with a third party, including an insurance producer, to establish and maintain a system of supervision of insurance producers under contract with or employed by the third party. An insurer would have to make reasonable inquiry to assure that the third party was performing the functions required and would have to take reasonable action under the circumstances to enforce the contractual obligation to perform the functions. An insurer could comply with its obligation to make reasonable inquiry by doing both of the following:

- Annually obtaining a certification from a third party senior manager that the third party was performing the required functions.
- Periodically selecting, based on reasonable selection criteria, third parties for a review to determine whether they were performing the required functions.

An insurance producer contracting with an insurer promptly would have to give a certification or give a clear statement that it was unable to meet the certification criteria, when requested by the insurer.

An insurer that contracted with a third party and that complied with the supervision requirements would be considered to have met its responsibilities to establish and

maintain a system of supervision or ensure that a system was established and maintained.

An insurer or insurance producer would not be required to do either of the following:

- Review, or provide for review of, all insurance producer-solicited transactions.
- Include in its system of supervision an insurance producer's recommendation to senior consumers of products other than the annuities offered by the insurer or insurance producer.

An insurer and an insurance producer would have to maintain or be able to make available to the OFIS Commissioner records of the information collected from the senior consumer and other information used in making the recommendations that were the basis for insurance transactions, for five years after the insurance transaction was completed by the insurer. An insurer could, but would not be required to, maintain documentation on behalf of an insurance producer. Records required to be maintained could be maintained in paper, photographic, microprocess, magnetic, mechanical, or electronic media or by any process that accurately reproduced the actual document.

Corrective Action for Violations

In addition to penalties provided for under Section 150 of the Code, the Commissioner could do any of the following:

- Order an insurer to take reasonably appropriate corrective action for any senior consumer harmed by the insurer's, or by its insurance producer's, violation of Chapter 41a.
- Order an insurance producer to take reasonably appropriate corrective action for any senior consumer harmed by the producer's violation of Chapter 41a.
- Order an insurance producer that employed or contracted with another insurance producer to sell or solicit the sale of annuities to senior consumers, to take reasonably appropriate corrective action for any senior consumer harmed by the producer's violation of Chapter 41a.

If corrective action for the senior consumer were taken promptly after a violation was

discovered, the Commissioner could reduce a penalty for a violation of the bill's requirements to assure, adopt, or establish a system to supervise recommendations in compliance with Chapter 41a.

(Section 150 provides that, if the Commissioner finds that a violation of the Code has occurred, he or she may order certain sanctions and penalties, including the payment of civil fines and license suspension, limitation, or revocation.)

NASD Rules

An insurer that complied with the NASD rules "NASD Manual, Conduct Rules Section 2310 (CCH, 1966)", or rules at least as stringent as Section 2310 pertaining to suitability, would satisfy the requirements of Chapter 41a for the recommendation of variable annuities.

Scope

The bill specifies that Chapter 41a would apply to any recommendation to purchase or exchange an annuity made to a senior consumer by an insurance producer, or an insurer where no producer was involved, that resulted in the purchase or exchange recommended.

Chapter 41a would not apply to any recommendation to purchase or exchange an annuity involving direct response solicitations, where there was no recommendation based on information collected from the senior consumer, or involving contracts used to fund any of the following:

- An employee pension or welfare benefit plan that was covered by the Federal Employee Retirement and Income Security Act.
- An employer-established or -maintained pension, profit-sharing, deferred compensation, or stock bonus plan regulated under Section 401(a), 401(k), 403(b), 408(k), or 408(p) of the Internal Revenue Code (IRC).
- A government or church pension or deferred compensation plan regulated under Section 414 of the IRC, or a deferred compensation plan of a state or local government or tax-exempt organization regulated under Section 457 of the IRC.

- A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.
- Settlements of, or assumptions of liabilities associated with, personal injury litigation or any dispute or claim resolution process.
- Formal prepaid funeral contracts.

Proposed MCL 500.4151-500.4165

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

According to OFIS, in recent years there has been an increase in complaints regarding the sale to senior consumers of annuities that may not be suitable investments for them because of the customers' age and financial situation. Seniors are particularly vulnerable to abuse in the form of unscrupulous sales tactics because they may have saved and accumulated wealth over many years and might not fully grasp the nature of annuity products and how investment in them would relate to the seniors' own circumstances. Currently, the OFIS Commissioner has the authority to take action against unscrupulous insurers or producers, but the burden of proof in these instances often is a barrier to effective enforcement because the purchaser must demonstrate that the producer or insurer acted improperly in selling a product that was not in the consumer's interest. Under the bill, however, the insurer or producer would have to determine the suitability of an annuity product for the consumer before the sale occurred. Strictly regulating the sale and recommendation of annuity products to senior consumers in this manner would provide a greater degree of protection for elderly investors and their assets than is currently afforded them.

Response: While the bill would offer some degree of protection to senior consumers and authorize the Commissioner to take enforcement actions, it could be improved on several grounds. Although the OFIS Commissioner could penalize insurers and producers, the bill contains no private right of action by consumers. Providing a private civil remedy, by allowing individuals to pursue legal claims against insurers or producers who sell or attempt to sell

unsuitable annuity products to senior consumers, would create another incentive for annuity sellers to ensure the suitability of the investment. Moreover, the bill's penalties would be insufficient to deter the practice of recommending and selling inappropriate annuity products to senior consumers.

Commissions earned on the sale of annuity products apparently are quite high and the penalties for consumers' borrowing in advance of an annuity's maturity are quite steep. The bill should require disclosure of these commissions and penalties to ensure that consumers were fully informed on the parameters of a transaction.

Also, while the bill would require an insurer or producer to maintain information provided by a senior consumer for five years, it would not require that the annuity recommendation or supporting documentation be maintained.

Supporting Argument

According to written testimony submitted to the Banking and Financial Institutions Committee by the American Council of Life Insurers (ACLI), model regulations for senior protection in annuity transactions have been the subject of much discussion and debate over a number of years. While initial versions proposed by the NAIC were strongly opposed by the insurance industry as being too broad and intrusive, in early 2003 regulators proposed a model that was limited to the sale of annuities to individuals 65 years of age and older, but covered both fixed and variable annuities. Insurers requested that the model provide safeguards for a seller's compliance with National Association of Securities Dealers rules pertaining to suitability. According to testimony before the Senate committee by representatives of ACLI, the resultant NAIC model bill has received the approval of regulators, insurance companies, insurance producers, and consumers. The ACLI officials told the committee that 13 states had adopted the model, either as legislation or regulatory structure. The aim is to have conformity in laws regulating annuity sales to seniors from state-to-state. According to OFIS, Senate Bill 880 (S-2) is based upon that NAIC model law.

Response: The legislation could provide broader consumer protections for Michigan citizens by applying to consumers

of all ages. Indeed, according to OFIS, the ACLI recently reversed its opposition to this concept and agreed to support a measure to extend annuity sale consumer protections to transactions with consumers of all ages. Based on that change of position, OFIS evidently expects that the NAIC will review the existing model and work toward expanding it to protect all consumers.

Opposing Argument

Annuities, particularly variable annuities, are more accurately characterized as investment tools than as insurance products. As such, they should be regulated as securities, not as insurance.

Legislative Analyst: Patrick Affholter

FISCAL IMPACT

The bill would have no fiscal impact on State or local government.

Fiscal Analyst: Elizabeth Pratt
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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.